

AAR 'flips' the Mauritius 'kart' citing *prima facie* Tax Avoidance

Snapshot

Authority for Advance Ruling (AAR) rejects Applicants' (Mauritius companies') application for ruling on taxability of capital gains on 'indirect transfer' of Indian assets pursuant to sale of Singapore Company's shares by holding that the question related to a transaction or issue designed *prima facie* for the avoidance of income-tax and thereby being squarely covered by the first proviso to section 245R(2).

In arriving at the conclusion, AAR relied upon various documents / facts like directors, authorised signatory for bank account, etc. and held that the "head and brain" and consequently, the control and management of the Mauritius Company was in the US and thereby investments were made through Mauritius merely to take benefit of the Double Taxation Avoidance Agreement between India and Mauritius (India – Mauritius DTAA) and thereby avoid tax.

Facts

M Co. 1, M Co. 2 and M Co. 3 (together referred to as "the Applicants") were Tax Residents of Mauritius with a GBL – 1 License. The primary objective of these companies was to carry out investment activities. The applicants held shares in S Co., a company incorporated in Singapore. Shares in S Co. were acquired by the three Applicants during the period 2012 through 2015. S Co. made further investments in various Indian companies and it derived substantial value from assets located in India. On August 18, 2018, the Applicants transferred certain shares of S Co. to L Co., a company based out of Luxembourg. These transactions were a part of an overall arrangement involving majority acquisition of S Co. by a US major from various shareholders including the Applicants.

Proceedings under section 197 of the Income-tax Act, 1961 ('the Act') ["197 Proceedings"]

It is worth noting that prior to the transfer, applications under section 197 of the Act for NIL withholding tax (WHT) certificates (referred to as '197 applications') were made by the Applicants to Tax Officer on August 02, 2018 who denied the applications citing ineligibility to India – Mauritius DTAA as the Applicants were not independent and control over decision making for the transfer was not with them. Accordingly, the tax officer provided withholding tax certificates dated August 17, 2018 prescribing specific rates for withholding tax (~ 6% to 8%).

Application to AAR

On February 19, 2019, the Applicants approached the AAR and the question put forth pertained to chargeability (both under the Act as also India – Mauritius DTAA) of gains arising to the Applicants from the transactions of sale of shares of S Co. to L Co.

Revenue's Objections

Revenue raised objections as regards admissibility of the Applications by taking recourse to all the three situations stipulated in the first proviso to section 245R(2) for not allowing an Application:

- Pendency of proceedings ("**Objection 1**")
- Case involved determination of Fair Market Value (FMV) ("**Objection 2**")
- Case related to a transaction or issue which was designed *prima facie* for the avoidance of income-tax ("**Objection 3**")

Objection 3 being the main objection, we have discussed below, Revenue's contentions, Applicants' contentions and Ruling by the AAR on the same:

Revenue's contentions

Revenue contended that in the course of 197 proceedings, all facts were examined in detail and it was concluded that the entire scheme was devised to avoid tax on capital gains. In order to put forth its contentions to argue that the transaction was designed *prima facie* for avoidance of income-tax, Revenue referred to various facts discovered during the course of 197 proceedings that indicated that the scheme was designed *prima facie* to avoid tax. The same are summarised below:

Ownership and Control

Applicants were not acting independently but only acted as conduits for the real beneficial owners

based out of the US. A US entity invested worldwide through web of entities based out of low tax jurisdictions which indicated that real control was not in Mauritius. Applicants were set up for making investments into India and funds were provided by Promoter based out of the US.

Decision Making

On a perusal of records of Board Meetings, it was contended that a Director who was based out of the US (US Director) had attended all Board Meetings wherein crucial decisions were taken and the Mauritian Directors were mere spectators or took advice from the US Director. It was further contended that the Applicants' decision making was fully subordinate.

Control over funds

It was contended that authority to operate bank account for transactions beyond USD 250,000 was with Mr. C, a US national, countersigned by one of the Mauritian Directors. It was also argued that Mr. C was not even on the Board of the Applicants. Majority of the other signatories were also not from Mauritius and such signatories were senior management personnel of the US entity.

Beneficial Ownership

It was submitted that the application made to Mauritian authorities at the time of GBL 1 License showed Mr. C as the Beneficial Owner of the Applicants, who was also the Founder of the US Entity.

Purpose of a Treaty

Revenue contended that a Treaty was to be read in good faith and that both, India – Mauritius DTAA and India – US DTAA captioned "prevention of Tax Avoidance" as one of the purposes of the DTAA.

Applicants' contentions

The Applicants contended that the transactions under consideration were that of sale of shares simplicitor undertaken between two unrelated independent parties which could not be considered as being designed to avoid tax. Applicants contended that holding structure was not relevant and it must be proven that the transaction (and not the structure) was prima facie entered into to avoid tax. The Applicants also contended as follows:

Ownership and Control

Applicants were managed and controlled by its Board of Directors in Mauritius in accordance with its constitution.

Decision Making

The decision to invest into and ultimately sell the shares of the S Co. was taken by Directors of the Applicants in Mauritius after discussions and deliberations.

Control over funds

Applicants' contended that mere fact that the Board had given a limited authority to certain persons to operate bank accounts would not ipso facto mean that the Applicants had not control over the funds. It was also contended that the Revenue could not show that the funds were not independently and beneficially not owned by the Applicants.

Beneficial Ownership

It was contended that mere fact that certain disclosures were made from a Mauritius Co. Law perspective would not ipso facto mean that the legal owner does not enjoy benefits of the investments for tax purposes. Such a logic would lead to unintended situations in all cases with foreign shareholders. Applicants had beneficially

held shares of Singapore Company and were not accountable to any third party.

Purpose of a Treaty

The Applicants submitted that they were neither sham nor conduit and Treaty benefit being claimed by them could not be considered as a measure of tax avoidance. Claim of Treaty benefit did not amount to tax avoidance. Mauritius Comprehensive Tax Treaty network with various countries (and not only India) facilitated efficient asset management and achieved a competitive return for the Applicant's investors.

Reliance was also placed on SC Ruling in the case of Vodafone International Holdings BV. Reliance was also placed upon AAR Ruling in the case of Star Television Entertainment Ltd. to argue that if there is a business rationale surrounding the transaction, it cannot be said to have been designed to avoid tax.

AAR Observations and Ruling

AAR held that the argument of Taxpayer that it was a transaction of sale simplicitor was too simplistic to be accepted. Though the holding-subsidary structure might not be conclusive proof for tax avoidance, purpose for which subsidiaries were formed indicate the real intention. It was an inescapable conclusion that the Applicants were set up to make further investments in order to take benefit of India – Mauritius DTAA. Movement of funds from the US (and not from Mauritius) was not a critical factor to determine existence of tax avoidance. In cases of Capital Gains, it is not only the transaction of sale of shares but also purchase of those shares which is relevant as it is a parameter to determine capital gains. Accordingly, entire transaction of purchase and sale was to be looked at.

Ownership and Control

As regards holding structure and ownership and control, AAR held that holding structure along with control and management of Applicants would be relevant factor for determining design of avoidance of tax. It held that Control and Management did not refer to the routine / day to day affairs but the overall control and the "head and brain" of the Companies. Mr. C was controlling the decision making through the US Director, who was accountable to him. Mr C also controlled the funds (as discussed below). Thus, the "head and brain" of the Applicants was in the US and not Mauritius.

Decision Making

AAR held that the observations of the Revenue that the Mauritian Directors were mere puppets of the US Director who was privy to all crucial decisions, cannot be negated.

Control over funds

As the principal bank account of the Applicants was maintained in Mauritius, it would have made sense if a local person based on Mauritius was appointed to sign cheques on behalf of the Directors. AAR observed that the Applicants were not able to explain as to why Mr. C was given that authority.

Beneficial Ownership

Mr. C was the beneficial owner of the Applicants, also an authorised signatory of the parent entity and also the sole director in the Ultimate Parent. These facts could not be a co-incidence.

Purpose of a Treaty

As per CBDT's Circular No. 682, benefit of India – Mauritius DTAA could be availed when a Resident of Mauritius sold shares of an Indian company

whereas in the Applicants' case, the gains were from sale of shares of S Co. and not Indian companies. Even pursuant to amended India – Mauritius DTAA, relaxation was given to sale of shares of Indian company and not otherwise. Exemption in respect of sale of shares of any other company was never intended. While the Applicant had referred to the Tax Treaty Network of Mauritius with various countries, it effect had made investments only in Singapore and taken benefits of India – Mauritius DTAA. Real intention accordingly was to obtain benefits of India – Mauritius DTAA.

Taking recourse to Supreme Court ruling in the case of Vodafone, AAR held that the Applicants' did not pass the tests laid down by Supreme Court in order to be eligible for India – Mauritius DTAA. In the context of Article 13(4) which is a residual clause for taxing capital gains, the AAR has held that the India – Mauritius DTAA only intends to exempt capital gains from sale of shares of an Indian company and not otherwise and hence, recourse cannot be had to Article 13(4) of India – Mauritius DTAA.

As regards the other two objections viz. pendency of proceedings and case involving determination of FMV, the AAR rejected the same by holding that there were no proceedings in respect of the Applicants that were pending at any stage and an application to AAR could be made once 197 proceedings were complete. It also held that the case merely pertained to chargeability of capital gains and not with respect to valuation and hence, the said objection was rejected.

KCM Note

In arriving at a conclusion that the case related to a transaction or issue which was designed *prima facie* for the avoidance of income-tax, AAR has relied upon the declarations submitted by the Applicants in Mauritius, made reference to persons who were authorised signatory for Applicants' bank accounts.

AAR has disregarded the corporate existence of the Applicants and applied a look-through approach. It came to a conclusion that the Applicants were set up merely to obtain tax benefit pursuant to India – Mauritius DTAA and had the investments been made directly from the US into India, such a benefit would not have been available.

Interestingly, AAR has also opined that the benefit of Article 13 should not be available in case of

Indirect Transfers as mere sale of shares of Indian entity is envisaged under the said Article of India – Mauritius DTAA. Though an AAR Ruling, it may have an impact on ongoing cases involving indirect transfers. AAR's reference to and reliance on SC Ruling in the case of Vodafone to distinguish between a "pre-ordained" transaction created for tax avoidance and a transaction which evidenced investment participation into India, seems to be misplaced.

It is important to note that the AAR has not ruled on taxability / chargeability of capital gains but only rejected the application for a Ruling on the ground that the case related to a transaction which was "*prima facie*" for avoidance of income-tax, which keeps other avenues open for the Applicants.

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